



ACA
COMPLIANCE GROUP
BEACON VERIFICATION SERVICES

OCTOBER 2009 UPDATE

ATTEST **BVS**

Hello everyone and welcome to the October edition of the Beacon newsletter. A firm's marketing efforts are a crucial aspect of business development, and firms must ensure that they keep regulatory requirements in mind. This month we will highlight these regulatory requirements associated with advertising from both a GIPS® and SEC perspective. Also, we will glimpse at the confounding issue of compounding and fees. Enjoy!

INSIDE THIS ISSUE

Advertising—GIPS® and the SEC	1	Beacon 5K Runners	4
The Joys of Geometric Linking	3	Upcoming Webcast	4

Advertising—GIPS® and the SEC

A critical component of our verification testing is the thorough review of the investment firm's marketing material and advertisements due to the propensity for errors to occur here. We can be completely confident in the accuracy and suitability of a firm's composite construction and performance calculations, but without ensuring that this information is accurately disseminated to the public, there is a certain level of discomfort regarding the firm's claim of compliance. As a result, and because the public arena is the most likely place that a firm's mistake will be noticed, Beacon pays particular attention to reviewing the marketing materials of all the firms with whom we work.

However, the required disclosures by the GIPS® that we review vary from the advertising requirements of the SEC. These differing, and sometimes overlapping, guidelines can be somewhat confusing, and often firms face a challenge in ensuring that both sets of requirements are included in their marketing pieces. Consequently, we take time to examine the advertising requirements of both the GIPS® and the SEC. To facilitate a better understanding of both sets of requirements, the remainder of this article will be broken into two sections: the GIPS® requirements, and the SEC requirements.

GIPS®

The set of GIPS® requirements which govern advertising is called the GIPS® Advertising Guidelines. If a firm chooses to advertise its claim of compliance, then the GIPS® Advertising Guidelines must be followed. If an advertisement does not mention the GIPS®, then the guidelines are only voluntary. However, we would encourage all firms to abide by the Guidelines as they serve as industry best practice and a good ethical roadmap.

Under the GIPS®, there are effectively two levels of advertisements. The first includes a claim (CONTINUED)



of compliance with the Advertising Guidelines and other qualitative information pertaining to the firm. The second, which is used if performance is being shown, contains all of the initial requirements but also includes performance-related information. These Advertising Guidelines can be found on page 48 of the GIPS® Handbook.

SEC

While the GIPS® have a stated number of explicit requirements which must be followed, the SEC's guidance on advertising is somewhat more ambiguous and open to interpretation. Rule 206(4)-(1) under the Investment Advisers Act of 1940 which governs advertisements by investment advisers prohibits "any untrue statement of a material fact, or which is otherwise false or misleading." However, this rule does not further elaborate on what constitutes these types of statements. For specific guidance one has to look to subsequent SEC interpretations which can be found in no-actions letters, releases, and guidance.

Perhaps the most pertinent of these no-action letters is the SEC's letter to [Clover Capital Management, Inc.](#) (October 28, 1986) which contains an itemized list of facts that, if not disclosed, could result in the advertisement being classified as "misleading." As a consequence, this list serves as a de facto set of required disclosures which firms should include in their advertisements. They are:

1. The extent to which the results reflect the deduction of advisory fees, brokerage fees or other commissions, and any other expenses that a client may have paid.
2. Whether the results reflect the reinvestment of dividends and other earnings.
3. Past performance is no guarantee of future results. Advertisements may not suggest or make claims about the potential for profit without also disclosing the possibility of loss.

4. The effect of any material market or economic conditions on the results portrayed. To illustrate, an adviser should not state that client accounts appreciated in value 25% without disclosing that the market generally appreciated 40% during the same period. This requirement is frequently met by comparing the performance results to that of a relevant index.



5. When comparing performance results to an index, all material facts relevant to the comparison must be disclosed. For example, an adviser should not compare performance results to an index without disclosing all of the facts that might make the comparison misleading, e.g. that the volatility of the index may be materially different from that of the adviser's strategy; that the holdings and weightings of the securities in the index may be materially different from the holdings and weightings of the portfolio shown, etc.

6. Any material conditions, objectives, or investment strategies used to obtain the results portrayed. For example, "The portfolio contains equity stocks that are managed with a view towards capital appreciation."

7. As applicable, the fact that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material. This requirement applies only to actual performance results (versus model performance results) and is intended to (CONTINUED)



prevent advisers from cherry-picking their best performing accounts.

There are numerous other considerations for which the SEC has issued guidance. Below are a few examples.

Regarding gross performance, in a letter to the Association for Investment Management and Research (December 18, 1996), the SEC staff clarified that advertising gross-of-fee performance in other than a one-on-one presentation would not be considered misleading if the advertisement included net-of-fees performance information that was presented with equal prominence.

In a letter to Horizon Asset Management, LLC (September 13, 1996), the SEC staff stated that actual performance results generated while at a previous firm may be presented under certain conditions and with certain disclosures, including that the performance returns were generated while the manager (or managers) was employed at another firm.

Regarding record keeping, rule 204-2(a)(16) under the Advisers Act requires registered advisers to maintain “accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations” used in an advertisement that is sent to ten or more people.

Because SEC registered firms that claim compliance with the GIPS® must adhere to these two different sets of advertising requirements, we understand that producing a fully compliant marketing piece can be a complicated endeavor. It is our hope that this article has somewhat simplified this process for you. As always, we would be more than happy to discuss with you or to provide you with guidance pertaining to the GIPS® Advertising Guidelines. For any questions on the SEC advertising guidelines, we would be happy to connect you with one of our colleagues at ACA who could provide you with further guidance in this area. Above all, we encourage all firms to remember these crucial elements of advertising, as well as the GIPS®’ overarching theme of “fair representation and full disclosure” as you seek out new business. ◀

The Joys of Geometric Linking

Geometric linking can be a fascinating tool. Of course, it’s probably most fascinating to performance people who tell jokes that have “Cariño smoothing” as the punch line. Nevertheless, given the recent market volatility and downturn, we have received several questions regarding the unusually low gross-to-net spreads and the cause behind them.

Most of you know that during periods of positive performance, the firm’s computed fees (if applied on a less than annual basis) are higher than its stated fees. For example, if a firm charges 1% annually to every client but applies 1/12th of the fee to arrive at the net monthly returns, the spread between the gross and net returns will be slightly higher than 1% at the end of the year. Conversely, in a period of negative perfor-

mance, the firm’s annual gross-to-net spread will be less than the stated 1%. The factor here is the compounding effects of the fees. The positive returns compound on each other to result in a bigger spread while the negative returns compound on each other to result in a smaller spread. This effect has been particularly observable during 2008 and 2009 given the dramatic swings in the market. ◀



Beacon 5K Runners



On September 12, Beacon's amateur cross country team took to the streets in Chattanooga's annual Symphony Classic 5K Run.

The run was to support the Chattanooga Symphony & Opera, including the numerous scholarships given to the youth orchestra. Overall, the race was an overwhelming success, with three out of Beacon's five runners placing in their respective age divisions. Runners included Justin Guthrie, Kamelia Dari, Coley McKinstry, Douglas Finlay, and Mary Sofo. ◀

Upcoming Webcast

Latest GIPS® Guidance and New Requirements for 2009 & 2010
November 3, 2009

This important webcast will address recent guidance and interpretations of the GIPS®. The Standards and their application are constantly evolving, and compliant firms "must comply with all applicable requirements of the GIPS® Standards including any updates, reports, guidance statements, interpretations, or clarifications published by CFA Institute." Firms that only follow the written Standards will most likely fall out of compliance if they are not regularly monitoring the latest guidance. We will share the latest guidance with you as well as give you an in-depth update on the unique issues addressed at the 2009 GIPS® conference.

Alicia Hyde, CIPM, Verification Manager

Charlie Stout, CIPM, CFA Level I Candidate, Verification Manager

Please use the following link to enroll: webcasts.acacompliancegroup.com